BRIEF IN SUPPORT OF PETITION

The Facts

The salient facts are the following. Others are referred to in the opinion of the District Court (R. 18-27).

The Debtor's sole asset was a large apartment house in New York City, subject to a first mortgage of $1,474,250, which fell due on October 1, 1937 (Ex. 3, R. 175, Ex. 4, R. 195, 202) and in which the mortgagee had issued certificates of participation in the amount of $1,325,000 (R. 322).

In March, 1934 it applied to the Banks for a loan of $54,000 in order to permit it to settle the unpaid claims of material men secured by a second mortgage on the property (R. 46). The Banks at the time were interested in the Debtor's affairs, Continental holding its unsecured note for $44,500 (R. 323), and Chemical holding, as trustee for both, some of the Debtor's capital stock under a deed of trust from Campbell, Debtor's former president, who had died, insolvent, in April, 1933 (R. 323), giving it full power of disposition over the stock, all dividends and proceeds of sale to be applied on account of Campbell's obligations to both Banks (Ex. 21, 338-344).

Each bank agreed to make a loan of $27,000 on the Debtor's collateral demand note, the collateral recited in the notes (which were identical) being the second bond and mortgage (not considered as having any value), and all stocks held by the Bank for the Debtor's benefit, cash and deposit balances held at any time (Ex. 2, 168-169). The notes authorized the Banks to apply the balance in any deposit account to any liabilities of the Debtor.

The Debtor's president, Ellinger, who applied for the loans, the officers of the Banks, Edwards of Chemical and Hasler and Gurock of Continental, and the lawyers who represented the Banks in the matter, Crouse and Gettinger,

all testified that the loans were made upon, and only upon, the liquid security of the rents, not actually assigned but to be pledged as collateral as they were deposited in accounts "which the Banks would control," and accumulating every six months (April and October, when both the semi-annual interest of $44,227.50 on the first mortgage and the semi-annual real estate taxes, about $21,000, would become due), so that, as Hasler testified, "there would be built up every six months an amount that could be used for offset purposes," and, as Edwards testified, he "relied on our right to resort to the cash balance," as the Debtor had no other asset on which to raise cash. (Ellinger, R. 46, 67-68, Hasler, R. 135-136, 138-139, Edwards, R. 128-129, 134, Gurock, R. 140-141, Crouse, R. 146-148, Gettinger, R. 102, 105-107, 108-110).

The Debtor also agreed to execute a formal assignment of the rents, whenever requested, but it was never requested, because it would involve a lot of bookkeeping (R. 109) and also, doubtless, because the first mortgage provided that the principal should become due, at the option of the mortgagee, if an assignment of the rents should be given without its written consent (Ex. 3, R. 178).

To secure and maintain at all times control over the rents, for they were not turned over so as to become the property of the Banks but were deposited in accounts in the Debtor's name, the Banks required four things, which were done, viz:—(1) that all the capital stock of the Debtor, having voting power, be transferred into the names of their nominees, (2) that there be a board of four directors, two to be nominated by the Banks, (3) that the managing agent deposit all rents collected, directly in accounts in the two Banks in the name of the Debtor, without depositing them in any interim account, and (4) that no withdrawals from these accounts be permitted except upon checks countersigned by one of the two directors nominated by the Banks (R. 326-327).

Each April and October, beginning with October, 1934, the Banks conferred for the purpose of determining whether

to apply the balances in the accounts to their notes or to continue the loans and release the moneys to pay interest and taxes (R. 329-330). Each time, until October, 1937, they decided on the latter course, notwithstanding that, beginning with October, 1935, the balances were never sufficient to pay interest and taxes, so that the Banks had to make temporary loans for the purpose, which continually increased, from $5,000 in October, 1935, to $16,800 in April, 1937 (R. 331-332).

Expenses of operation and maintenance were always paid as they accrued (R. 331).

On October 1st, 1937, when the principal of the first mortgage fell due, foreclosure was authorized under the New York Moratorium Law, if either interest or taxes should not be paid. The Banks decided at their usual conference, over the protest of the Debtor's president, not to advance any money to permit payment of interest and taxes and, although the balances were sufficient to pay the interest, they set off on October 19th against the Debtor's notes the entire balances in the accounts, Chemical thus applying $17,332.26 to the balance of $18,641 due it and Continental applying $27,327.41 to the balance of $59,702.03 due it (R. 62, 119, 331).

Immediately upon hearing of this action the first mortgagee demanded and obtained, under threat of foreclosure, an assignment of the rents to which the Banks consented at the foot (R. 93, 120). The first mortgagee thus took over the management of the Debtor's only asset, its apartment house, and, though the Debtor remained alive, it no longer had control over its property or conducted its business in the usual manner.

Within three months, viz. on January 5th, 1938, the Debtor's directors, the two nominated by the Banks being present, resolved to file a petition for its reorganization under § 77B on the ground that it was unable to pay its debts as they matured and such a petition, containing the same admission, was filed and approved on January 8th (Ex. 4, R. 183-213).

Argument as to First Causes of Action

Necessary Elements

The four elements necessary for recovery under the first causes of action are

(1) that insolvency of the bankrupt (Debtor) existed, or was imminent, at the time of the alleged preferential transfer,

(2) that the transfer resulted in a preference,

(3) that the transferee knew, or had reasonable cause to believe, at the time of the transfer, that it would result in a preference, and

(4) that the bankrupt (Debtor) intended to give a preference.

Irving Trust Co. v. *Chase National Bank of the City of New York,* 72 Fed. (2d) 668 (C. C. A. 2).

Insolvency of the Debtor, if Not Existent, Was Imminent

The word "insolvency", as used in Section 15 of the New York Stock Corporation Law, means inability to meet one's obligations as they mature, and not an excess of liabilities over assets.

> *Childs* v. *County Trust Co. of New York,* 6 Fed. Supp. 821, 823, affirmed without opinion in 70 Fed. (2d) 1012 (C. C. A. 2).

Or, as Woolsey, J. expressed it, inability as a going concern, having regard to the amount and maturities of its obligations and the amount and nature of its assets, to realize on its assets so as to meet its obligations as they fall due.

> *Willcox* v. *Goess,* 16 Fed. Supp. 350, affirmed on this point in 92 Fed. (2d) 8 (C. C. A. 2).

Here, the Debtor's only assets on October 19, 1937 were (1) the balances, $44,659.27, in its deposit accounts in the Banks, (2) its apartment house, subject to an overdue first mortgage of $1,474,250, and (3) current rentals of about $2,900 (Ex. 17, R. 318). (The leases were hardly a saleable asset.) The schedule of assets annexed to its petition for reorganization lists rentals due from tenants of apartments vacated, etc. of approximately $23,000, but they were probably largely uncollectible.

The Debtor's obligations on that day were (1) $1,474,250, principal, and $44,227.50, interest, on its first mortgage, both of which had fallen due on October 1st, (2) real estate taxes, approximately $21,000, payable that month, without penalty, (3) $78,638.34 due the two Banks on its demand notes, (4) notes for $24,130, with accrued interest of approximately $6,000, held by the Aeson Corporation, secured by a junior interest in the second mortgage (Ex. 4, R. 204, 212), and (5) about $2,700 of operating and maintenance bills (Ex. 17, R. 318), subsequently paid from the current rentals of $2,900.

The net income, before interest, from the apartment house had steadily fallen from $120,832.86 for 1934 to $92,411.68 for the 12 months ending September 30, 1937 (R. 150). For two years it had had to borrow, every April and October, increasing amounts in order to pay interest and taxes.

The Circuit Court of Appeals did not consider the question of insolvency but the trial court held that, because from May to October, 1937, it had been able to meet its obligations, as they matured, it was not insolvent on October 19th, nor was insolvency imminent (R. 30). But the only obligations which it had to meet during this period were the expenses of operating and maintaining its apartment house. The trial court entirely overlooked the interest and taxes due in October, to meet which it had to accumulate funds, and the fact that the amounts accumulated were approximately $21,000 short.

On either test, inability to meet its obligations as they matured or inability to realize on its assets so as to meet its obligations as they fell due, the Debtor was insolvent on October 19th. In fact, its insolvency had been imminent, if not actual, at least since April, 1937, when the Banks, in order to avoid a default on the mortgage and consequent foreclosure which would have wiped out their equity, had had to make a temporary loan of $16,800 to the Debtor to enable it to pay interest and taxes. Indeed, it might be argued that it had been insolvent ever since October, 1935, when the Banks had first been obliged to lend it $5,000 to pay interest and taxes.

Furthermore, the Debtor admitted its insolvency when, in its petition for reorganization, it stated, as required by §77B(a), that "Debtor is unable to pay its debts as they mature" (Ex. 4, R. 207). This has been held to constitute an admission of insolvency in the sense used in the second sentence of §15.

In Re Wil-low Cafeterias, Inc., 22 Fed. Supp. 617, 619, reversed, but on other grounds, in 95 Fed. (2d) 306 (C. C. A. 2).

The Setoffs Resulted in Preferences

Whether these setoffs resulted in the Banks' obtaining a greater portion of their claims was not considered by either of the lower courts. The evidence, however, showed conclusively that this was the result.

On October 19th, 1937, the Debtor owed $44,227.50, interest on its first mortgage. The holders of the certificates of participation in the mortgage never received any of this interest. Payments on account of interest were made during the pendency of the reorganization proceedings but, when the plan of reorganization was approved on November 14, 1939, the unpaid interest amounted to $82,567.17, $1,556,817.17 less $1,474,250 (Ex. 13, R. 280), an increase

of $38,339.67 over the amount due on October 19th. Chemical had received $17,332.26 on account of the balance of $18,641.00 due it and Continental $27,327.41 on account of the balance of $59,702.03 due it.

As the court also found (R. 280) that the fair value of the premises was only $1,400,000, the difference of $156,817.17 constituted a general claim upon which likewise nothing was paid. Also, notes for $24,130 held by Aeson Holding Corporation, secured by a junior interest in the second mortgage were wiped out (R. 278, 281).

The test is the actual result when the estate is liquidated and distributed, either in bankruptcy or reorganization.

Palmer Clay Co. v. *Brown*, 297 U. S. 227, 229.

Knowledge of the Banks that the Setoffs Would Result in Preferences

That the Banks knew that the setoffs would result in preferences to them follows from their knowledge of the Debtor's financial situation and that application of the balances in the accounts would leave nothing with which to pay the overdue interest and taxes.

The Debtor Intended to Give the Banks Preferences

The Circuit Court of Appeals held that there was no intent to prefer, for it was "obvious that the rents deposited prior to October 18 were not specifically for the purpose of effecting a preference to the Banks," that "the only way an intended preference can be worked out is to rely on the original agreement entered into in 1934," but that "it is not possible to sustain an intent through the vicissitudes of three years of business dealings," because "the debtor knew that its accounts might be debited at any moment," which "is not the same as saying that money

was deposited so that it would be debited." (R. 365), and that, therefore, the usual banker's lien rule applied.

This conclusion that there was no intent to prefer rests upon the supposed abrogation of an agreement which, the court admitted, was made in 1934. The testimony that there was such an agreement, referred to at pages 9-10, *supra*, was unanimously to the effect that, when the loans were made, it was understood that a fund would be built up, every April and October, to which the Banks could resort for offset purposes, that the loans would not have been made otherwise and that the deposits in this fund were not subject to free disposition by the Debtor because the Banks controlled the right of withdrawal at all times.

A year later, when Longua, representing the junior interest in the first mortgage, sought a modification of the mortgage so as to provide for more frequent interest payments or deposits, monthly, bi-monthly or quarterly, so as to be relieved of his semi-annual worry as to whether interest and taxes were going to be paid, the Banks refused to make any change, saying that they wanted their loans to remain liquid, "so that twice a year they would have the maximum amount on hand * * * so they would be in a position to liquidate to the greatest extent, in full, or at least partially, the amount of the loan" (R. 90-92). Though all the Banks' officers testified after Longua, none of them contradicted his testimony.

There is no evidence whatever that this original understanding or agreement was ever at any time modified or terminated. In fact, the Banks stipulated that every April and October they conferred "for the purpose of determining whether or not they would apply the amounts on deposit * * * or would continue said notes and release the funds to pay taxes and interest" (R. 329-330).

Why it is "not possible to sustain an intent through the vicissitudes of three years of business dealings" is not at all clear. The Circuit Court of Appeals gave no reason for its assertion. And the rule has always been that a

situation or agreement once shown to exist is presumed to have continued until the contrary has been shown or until facts have been adduced from which it may be fairly inferred that the situation or agreement has been changed. No such evidence, however, was here produced. In fact, the situation remained unchanged throughout the entire period from March, 1934 to October, 1937, except that the Debtor's net operating income kept declining and its financial condition kept getting worse.

The Circuit Court of Appeals referred to its earlier decisions in *Kolkman* v. *Manufacturers Trust Co.*, 27 Fed. (2d) 659; and *Matters* v. *Manufacturers Trust Co.*, 54 Fed. (2d) 1010, both cited with approval many times, in the latter of which it had held that "a deposit made in ordinary course of business, over which the depositor means to keep full control, is not a preferential transfer," and that "in a case like this, the bank must understand that the account is being built up so as to be available at the proper time for seizure," and that "the deposit becomes a transfer because the depositor means it to be such; that is, he means not to exercise his right of withdrawal as to all of it, but to leave some part until that right is gone." But, apparently for the reasons above stated, it departed from these decisions and also failed to apply the qualifications upon a banker's right of set off laid down by this court in the *Massey* case.

Here, the Debtor did not mean to keep full control over its deposits; it had given up that right when it agreed that no moneys could be withdrawn except with the consent of the Banks. Here, also, the Banks understood during the entire three year period that the accounts were being built up so as to be available at the proper time for seizure (i. e. whenever they decided to seize).

That deposits not made in the ordinary course of business but made for the purpose of creating a fund which the bank may seize and set off against the depositor's note whenever it desires to do so are not such deposits as may

be set off under the rule of the *Massey* case has also been recognized in other Circuits. See

Frankford Trust Co. v. *Comber,* 68 Fed. (2d) 471 (C. C. A. 3), affirming 5 Fed. Supp. 659;
Citizen's National Bank of Gastonia, N. C. v. *Lineberger,* 45 Fed. (2d) 522, 529 (C. C. A. 4);
In re Almond-Jones Co., 13 Fed. (2d) 152, 156, affirmed *sub nomine Union Trust Co.* v. *Peck,* 16 Fed. (2d) 986 (C. C. A. 4);
German-American State Bank v. *Larimer,* 235 Fed. 501 (C. C. A. 8).

In *Kentucky Rock Asphalt Co.* v. *Helburn,* 108 Fed. (2d) 779, 781 (C. C. A. 6) the court said, citing the *Massey* case,

> "In general, it is the deposit of money in a bank, with the right to withdraw it, which constitutes the relationship of debtor and creditor between the bank and the depositor. If the money is * * * deposited under circumstances which give the depositor no right to control it, the relationship does not exist."

The District Court held that the evidence did not justify a finding of intent to prefer the Banks at the times when the deposits were made or on October 19th, 1937, because the deposits were not made in contemplation of winding up as an impending fact and the Debtor was continuing to manage and operate its apartment house with every hope and intention of being able to make a satisfactory adjustment with respect to interest and amortization on its first mortgage, when that mortgage became due (R. 31). But the mortgage had fallen due on October 1st and it had failed in making any adjustment.

In Re Almond-Jones Co., Inc., 13 Fed. (2d) 152, 157 the court said that it was possible that new capital might be obtained and a compromise made with creditors and the bank make a new loan, restoring the funds withdrawn, but, in the meantime, the deposits were made, not in the belief

that the bankrupt might withdraw them at will, but with the expectation that the bank would set them off, and the setoff was disallowed and affirmed on appeal (16 Fed. (2d) 986).

Argument as to Second Causes of Action.

Debtor had failed to pay its obligations, when due.

On October 19, 1937 the interest on the first mortgage had fallen due and was never paid. The District Court held (R. 26, 31-32) that this did not constitute a refusal to pay an obligation, when due, because the Debtor had until October 20th to pay the interest before being in default, citing *Barker* v. *472 Fulton Street Corporation,* 24 N. Y. Supp. (2d) 570, in support. This case held that a corporation had not failed to meet its obligation to pay rental under a lease on the first of each month, because it had always paid on the 10th or 12th. It was, however, modified on both the law and the facts in 262 App. Div. 892, and recovery of the alleged preferential payment directed.

It was argued below that because the mortgage contained a clause providing that the principal should become due, at the option of the mortgagee, if default for twenty days in payment of interest occurred (Ex. 3, R. 177), interest was timely paid, if paid at any time during such period, and that the mortgagee had acquiesced in such arrangement. But such clauses only accelerate the principal. They do not extend the due date of the interest, for the mortgagee could have brought suit on October 2d to collect the interest. *Malcolm* v. *Allen,* 49 N. Y. 448.

Nor can acceptance of interest after the due date operate to extend the due date in the future, especially where, as here, the mortgage provides that failure to insist upon strict performance shall not be construed as a waiver or relinquishment for the future of any covenant (Ex. 3, R. 181).

The Circuit Court of Appeals did not pass on this question, although it remarked that there was much to be said

in support of the position that custom had sanctioned the payment of interest at any time up to the twentieth day of the month (R. 366-367).

The Banks were Stockholders of the Debtor

On October 19, 1937, all the capital stock of the Debtor, with the exception of four shares in the names of the four directors, had been transferred to, and stood on its books in the names of, C. A. England & Co. and Tag & Co., nominees of the Banks (R. 327-328, Ex. 15, R. 919-921).

The District Court did not consider this question but the Circuit Court of Appeals held (R. 366) that the Banks were not really stockholders but creditors and that to call them stockholders would destroy a security device, viz. tying up the voting stock, which §15 was really not designed to hit.

But the reason for the enactment of §15 must have been to prevent those in actual control of a corporation, whether stockholders, directors or officers, from transgressing the well settled rule of equity prohibiting such persons from taking advantage of their knowledge and position by appropriating to themselves the assets of the corporation to the exclusion of other creditors. If that was the purpose, then whether the Banks held the stock as security, merely for voting purposes, i. e. control, or as absolute owners for a valuable consideration, is immaterial. The Banks, by having all the Debtor's capital stock transferred to their nominees, by having two of their nominees elected to its board, limited to four directors, thus acquiring practical control thereof, and by requiring that all checks on the Debtor's bank accounts must be countersigned by one of these two directors, in practical effert constituted themselves the corporation. They became its real owners, even though it be presumed, as the Circuit Court of Appeals did, that they had no desire to become owners.

There is no reported case, State or Federal, in which the meaning of the term "stockholders" in the first sen-

tence of §15 or its applicability to such a situation as is here presented has been considered. But we fail to see why persons to whom stock has been transferred on the books of the corporation, whether as collateral, as part of it clearly was (R. 207, Ex. A, R. 1060-1071, Ex. 20, R. 1008), or only to insure voting control, as some might have been (R. 322-324, Ex. B, R. 1072-1074), should not be considered as stockholders under this statute, as they have been under other statutes.

When stock pledged as collateral is transferred into the name of the pledgee, the pledgee becomes a stockholder and liable under a statute holding stockholders liable for the debts of the corporation.

Rosevelt v. *Brown,* 11 N. Y. 148;
Van Tuyl v. *Robin,* 160 App. Div. 41, affirmed in 211 N. Y. 540.

And also liable for assessments under the National Banking Act.

National Bank v. *Case,* 99 U. S. 628.

Such transferees have all the rights of stockholders.

Poole v. *West Point Butter & Cheese Association,* 30 Fed. 513, 518.

A stockholder is one who appears on the corporate books as owner and, therefore, entitled to a voice in its management.

Lee v. *Riefler & Sons, Inc.,* 43 Fed. (2d) 364.

CONCLUSION

The petition should be granted

Addison S. Pratt,
Petitioner in Person.